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ECONOMIC TRENDS

PROVINCIAL GOVERNMENT FINANCE

A HISTORICAL PERSPECTIVE

1. Introduction

Statistics Canada has maintained statistics on provincial government finances for many years and these are compiled in a uniform way for all provinces and the federal government in what is known as the Financial Management System. (FMS). It provides a standard classification for both expenditures by function, and for revenues by source. While there have been revisions to the system over the years the end product is a unique source of information permitting comparison of government finances across provinces, between levels of government, and over the passage of time. The data is largely based on official Public Accounts although it does not follow the accounting system of any particular province, including our own Province. It is based on a cash paid/received system, rather than accruals and it attempts to consolidate all provincial functions together, including some that Provinces generally exclude, such as Workmen's Compensation. It also combines capital expenditures with operating spending, and does not identify sinking funds as such. Thus it is a highly aggregated version of provincial revenues and expenditures.

The balance between Gross Expenditures and Gross Revenues is not equivalent to the Province's current account deficit, and is referred to as the Gross General Difference. In 1982/83 for example, the Province's deficit on Current Account in the provincial Public Accounts was $16.0 million, and its surplus for 1981/82 was $6.3 million. In terms of the FMS, the Gross General Difference was $-23.1 million in 1982/83 and +$5.45 million 1981/82. This figure is similar to the change in the Net Debt position as recorded in the Public Accounts of the Province of Prince Edward Island although, again, they are not identical. In 1982/83 the change in Net Debt was $-26.9 million.

The statistics are published by Statistics Canada in the publication "Provincial Government Finance", Catalogue 68-207, and more recently they have provided preliminary statistics for the current and previous two years on the computerized CANSIM base. This paper examines the period 1950/51 to 1983/84

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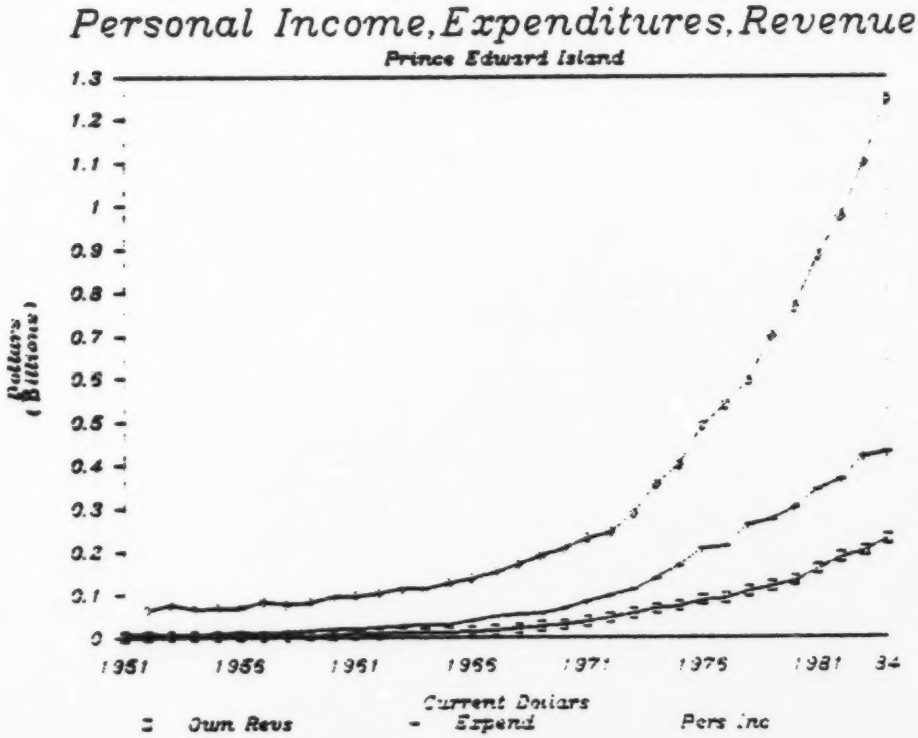
for the Province of Prince Edward Island. The last two years' data are preliminary in nature and some adjustments were incorporated into 1983/84 numbers in view of a few errors which Statistics Canada acknowledges were made in the statistics for that year.

2. Brief Review of Provincial Government Finance for Prince Edward Island

It is interesting to look at general trends over the 33 year period 1950/51 to 1983/84. In the years 1950/51-1954/55 the Province's total Gross Revenues ranged between $7.2 million and $9.4 million per year, while Gross Expenditures were only $8.2 million to $10.1 million. Provincial finances were clearly of a different order of magnitude than today. By comparison, in 1983/84 Gross Expenditures of the Province were $434 million on Revenues of $442 million. That year was only one of seven since 1950/51 when the Province recorded a gross surplus.

There is an inherent problem in making statistical comparisons of financial data over so long a time period because of the impact of inflation on dollar values. Diagram 1 displays gross provincial

Diagram 1



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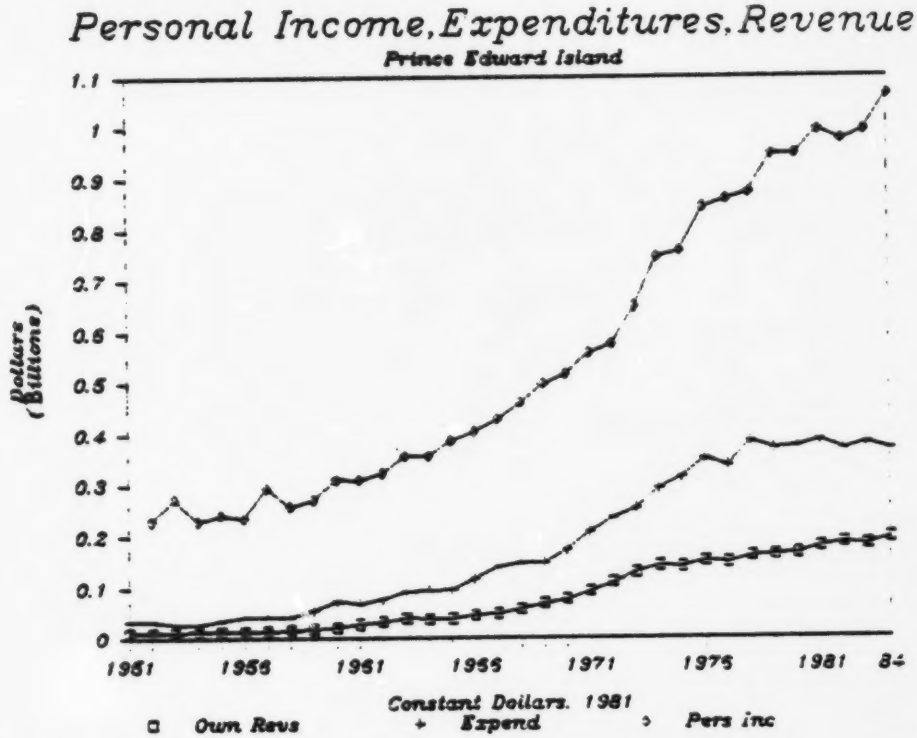
expenditures, total personal income and provincial own source revenues, in current dollars for these years. As one can see, it is difficult to discern trends. In order to make more meaningful comparisons we have converted these values to 1981 Constant dollars by dividing the data by the Consumer Price Index. The result, for the totals is shown in Diagram 2. This diagram reveals that provincial expenditures expanded significantly

Diagram 2



up until 1978 after which point they have been in a small decline. As a percentage of personal income they measured approximately 13 per cent in the early 1950's rising to about 40 per cent of personal income 1972-1978. In 1983/84 they measured 36 per cent. Own source revenues of the Province valued about 6 per cent of personal income in the early 50's and they rose to about 19 per cent in the early 70's since when they have varied between 17 and 19 per cent of personal income per year.

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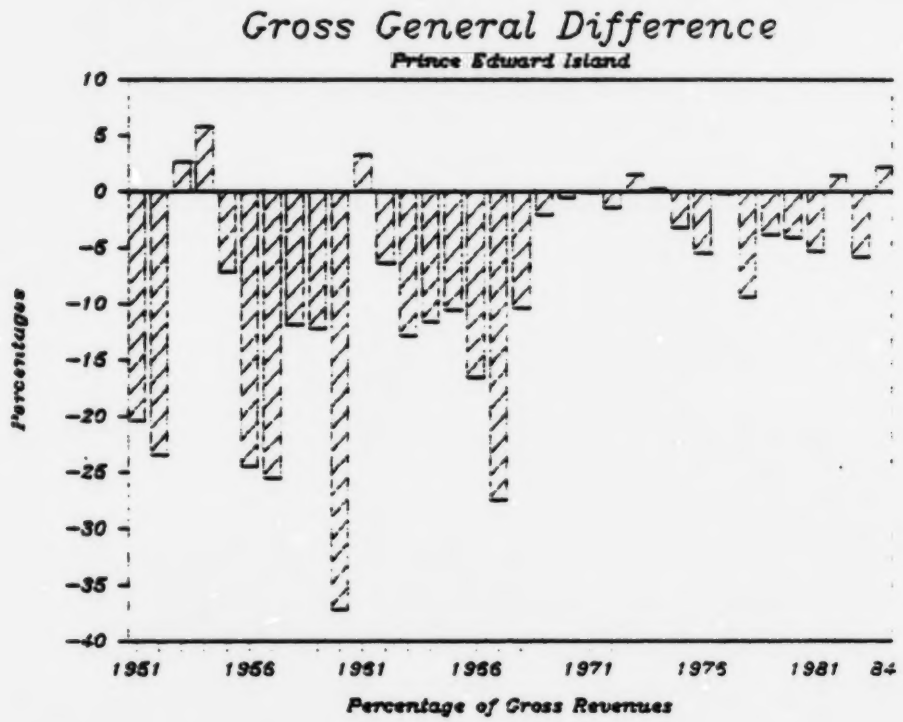
The Gross General Difference recorded its largest negative value in 1982/83 in current dollars. Yet in constant dollars it was far greater in 1977/78 and 1966/67. More interestingly, as a proportion of Gross Revenues the value of the Gross Difference is much smaller today than in earlier years, as can be seen in Diagram 3.

Diagram 3



One can discern three general phases in the history of the provincial finances during the past 33 years. Up to 1966 provincial revenues expanded fairly slowly, based on slow income gains, increased tax effort and increased federal transfers. The second phase extended from 1966 to 1977/78. During this phase federal transfers to the province increased very significantly. Own source revenues also accelerated with income gains and revenue measures.* However, in the last half of this phase, the Province reduced its tax effort somewhat as its financial position was substantially strengthened. The

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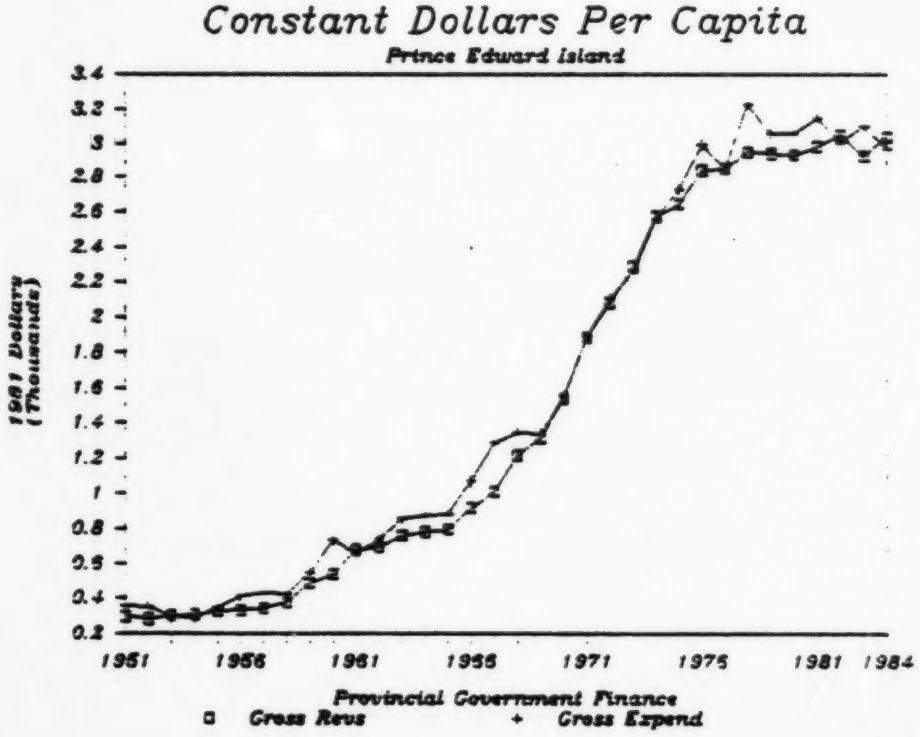
* Including the transfer of tax points from the federal to the provincial government.

third phase extends from 1978/79 to the present. This phase is entirely of a different character to the previous two. It is marked by a distinct decline in federal transfers in constant dollar terms, slowing economic gains, and measures by the Province to increase provincial own source revenues. It was a period of reductions in provincial government services, which was accentuated by the pernicious impact of rising debt charges, despite the relatively limited financial requirements of the government. This general picture can be seen in Diagram 4, showing total revenues and expenditures in constant dollars, on a per capita basis.

Diagram 4



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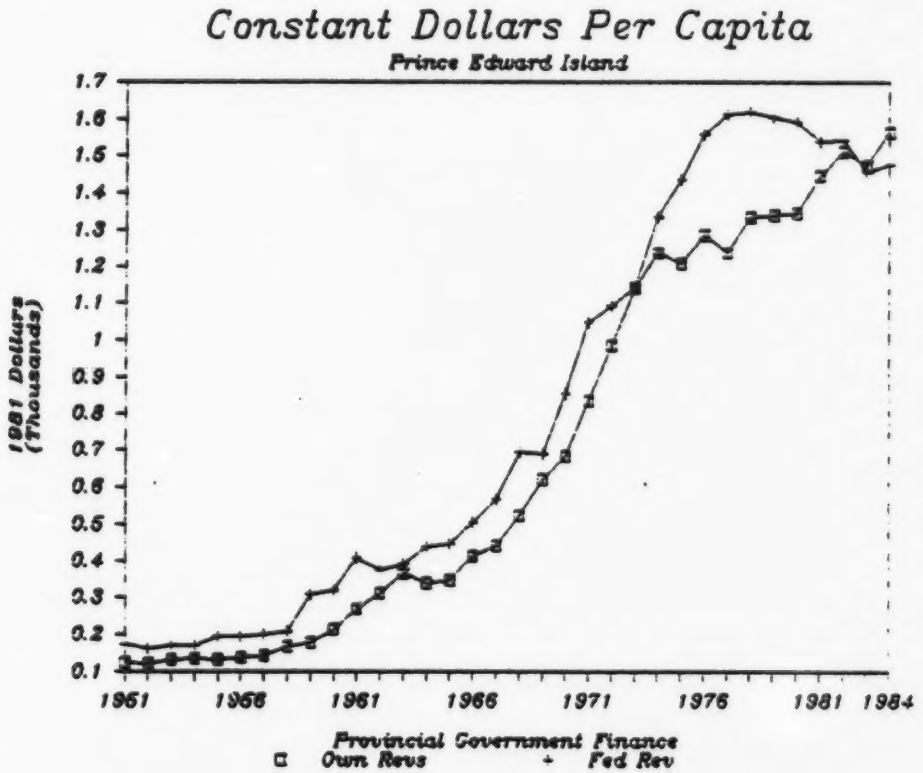
3. Provincial Revenue Trends

The general pattern of provincial revenue gains can be seen in Diagram 5, which distinguishes between federal transfers to the Province and own source revenues. The federal transfers

Diagram 5



exceeded the value of provincial own source revenues up until 1982/83. The last two years are most unusual in this regard. One can identify their extraordinary growth from the late 60's and the significant divergence in their growth paths from 1972. Federal transfers peaked, in terms of constant dollars per capita, in 1977/78 since when they trended downward, with a small improvement in 1983/84.

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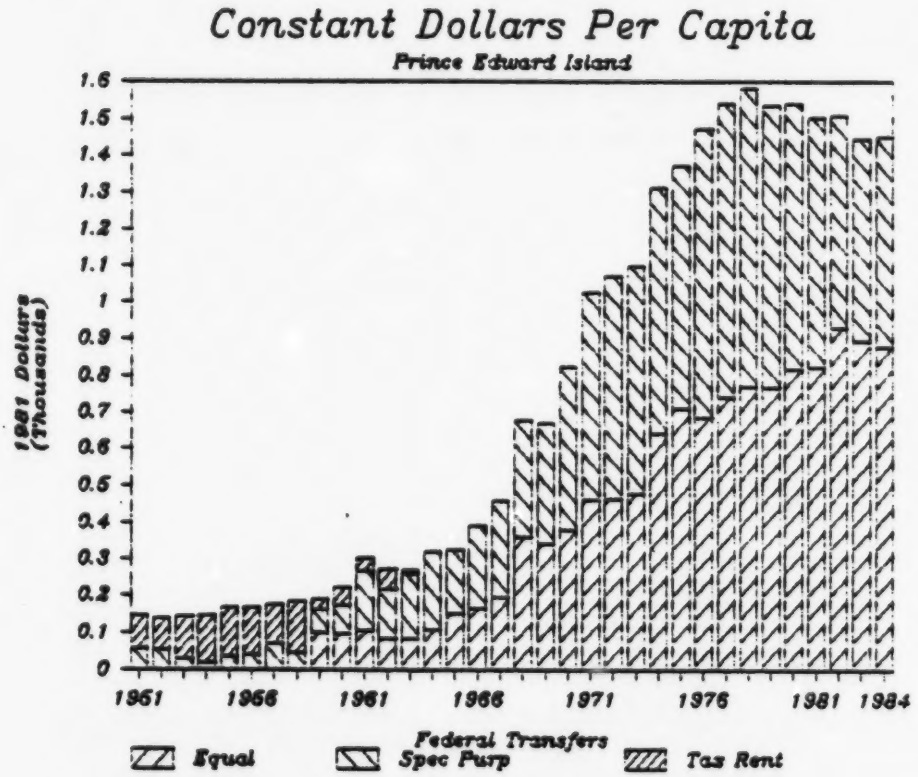
Diagram 6 shows the major federal transfers in constant dollars per capita. Up until 1958 they were largely in the form of tax rental agreements, which were paid in lieu of provincial income taxation. Equalization provided the dominant

Diagram 6



transfer from 1967 although its growth ceased after 1981/82. The major cause of the sharp uplift in federal transfers to 1978 was the added impact of "Specific Purpose" transfers. This is a combination of several transfers including among others the Development Plan and health and post secondary education. The phasing out of the Development Plan is the major cause of the decline in federal transfers since 1978.

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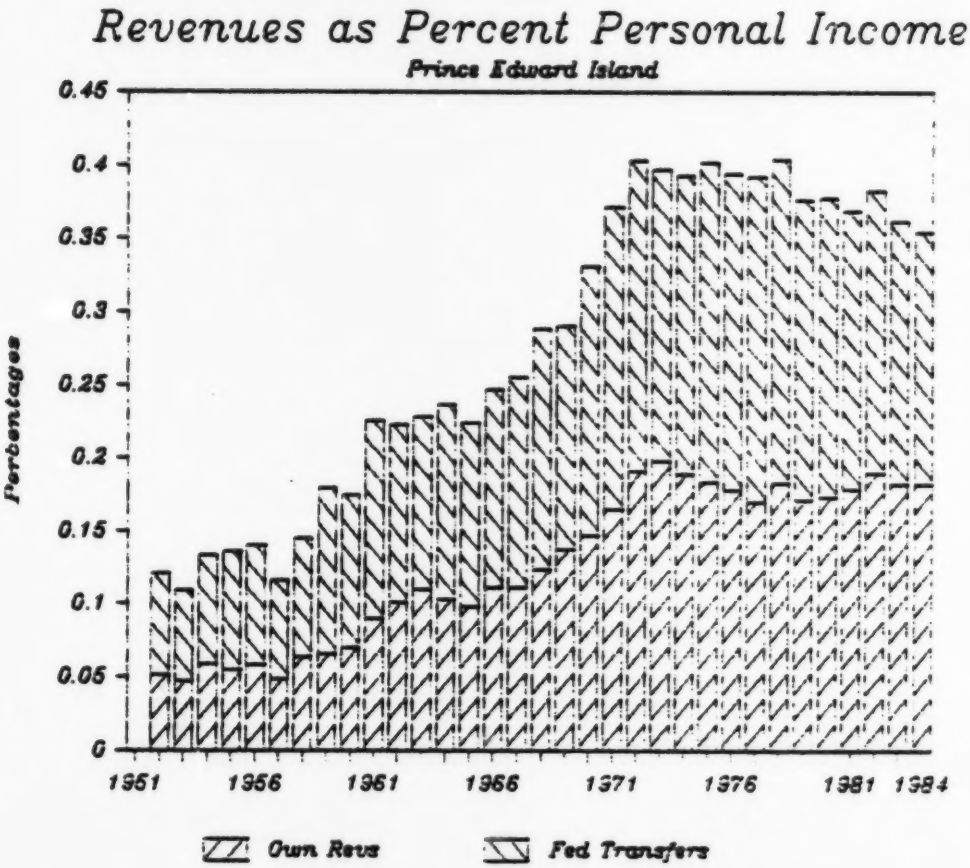
On the other side of the coin, as could be seen in Diagram 5 provincial own source revenues continued to improve generally, right up to the present. Essentially this is the result of the expanding economy and rising incomes coupled with the effect of various tax measures.* When viewed as a percentage of personal income, in Diagram 7 one can see that provincial own source revenues trended upwards to 1973, and then trended

Diagram 7



down to 1977/78. Movement to an ad valorem gasoline tax, increased sales tax rates and increased taxation of liquor, among other revenue measures have prevented further slippage since 1978. However the weak economy 1980 to 1982 itself damaged provincial own source revenues, as consumer spending and housing were very weak.

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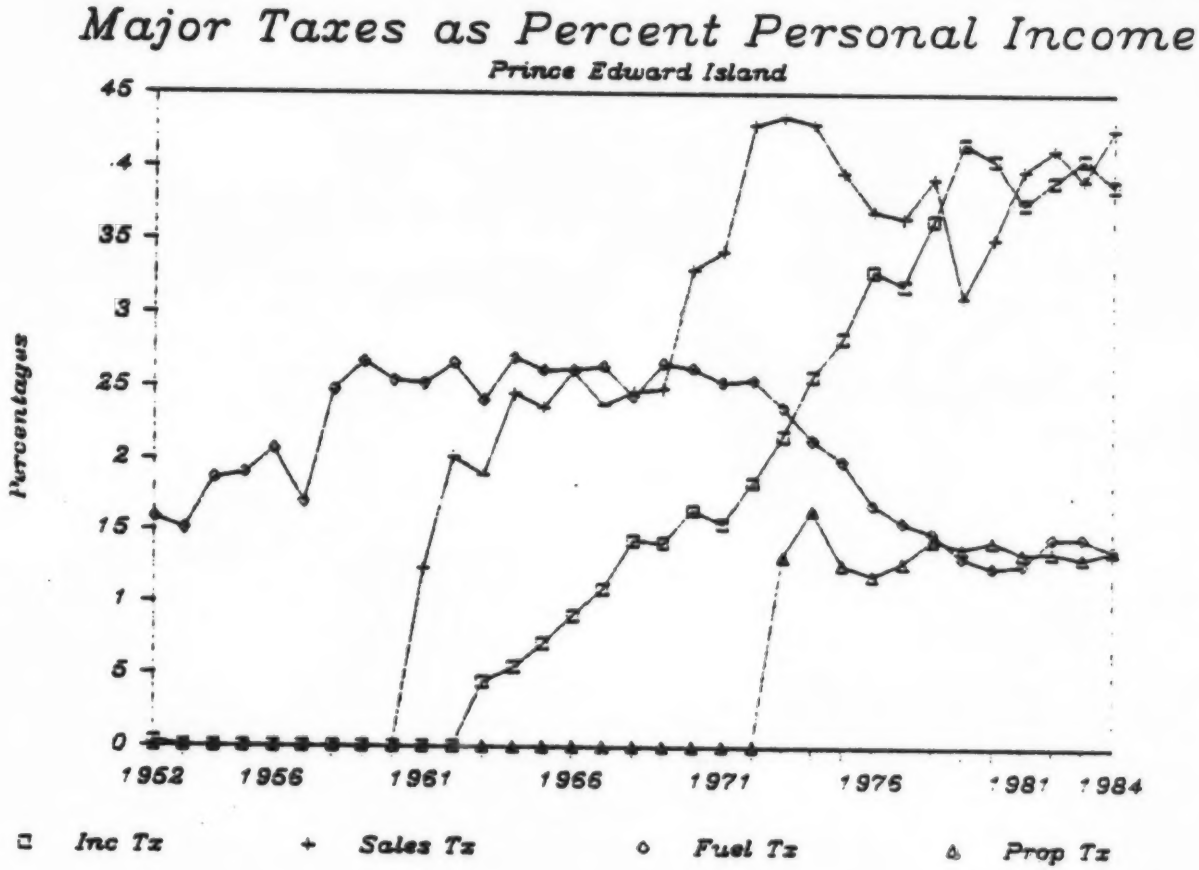
* Including the transfer of tax points from the federal to the provincial government, as occurred 1977/78 under Established Program Financing.

Diagram 8 displays four of the province's major tax sources in terms of their percentage of total personal income. Dominating tax revenues to 1966 were taxes on motive fuels. From 1966-1971

Diagram 8



sales tax revenues led provincial tax revenues. Increased exemptions (from clothing) reduced the importance of the sales tax 1972-1978. The tax on motive fuel also declined in this period. The provincial property tax was introduced in 1972, together with school consolidation, and it has barely kept pace with incomes subsequently. Most significant, the personal income tax increased rapidly to 1978*since when it declined as a percentage of personal income. The improved economy in 1983 led to a significant increase in sales tax revenues 1983/84, but it is interesting to note that the revenues derived from sales tax, as a percentage of personal income

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* This includes the impact of the transfer of tax points noted previously 1977/78.

still remained below the level achieved 1971-1973, as a percentage of personal income. Overall, as a percentage of personal income the provincial government's own source revenues in 1983/84 still remained below the levels reached in the early 70's.

5. Provincial Expenditures

Total provincial expenditures have followed trends in revenue growth. The following three charts show the changing pattern of provincial spending from the early 1950's to 1978, which was the peak of expenditures, and 1984, the most recent year. In the early days about one third of all provincial

Diagram 9(a)

Distribution Expenditures 1951

Prince Edward Island

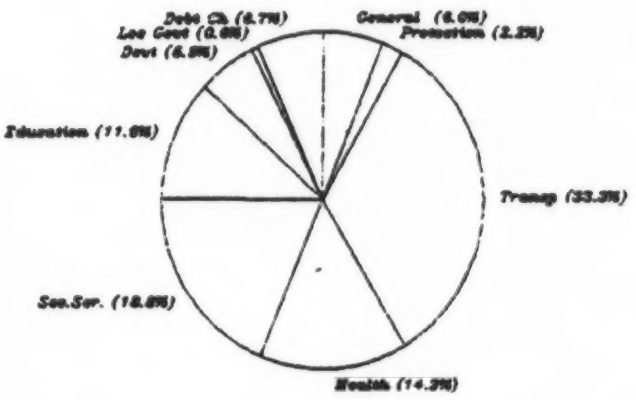


Diagram 9(b)

Distribution Expenditures 1978

Prince Edward Island

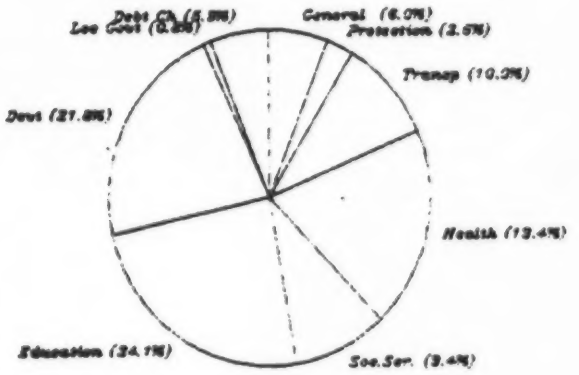
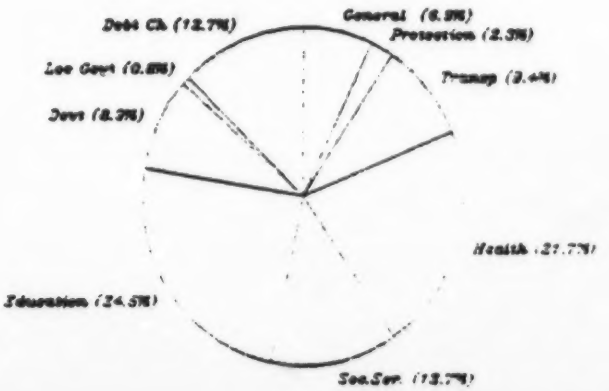


Diagram 9(c)

Distribution Expenditures 1984

Prince Edward Island



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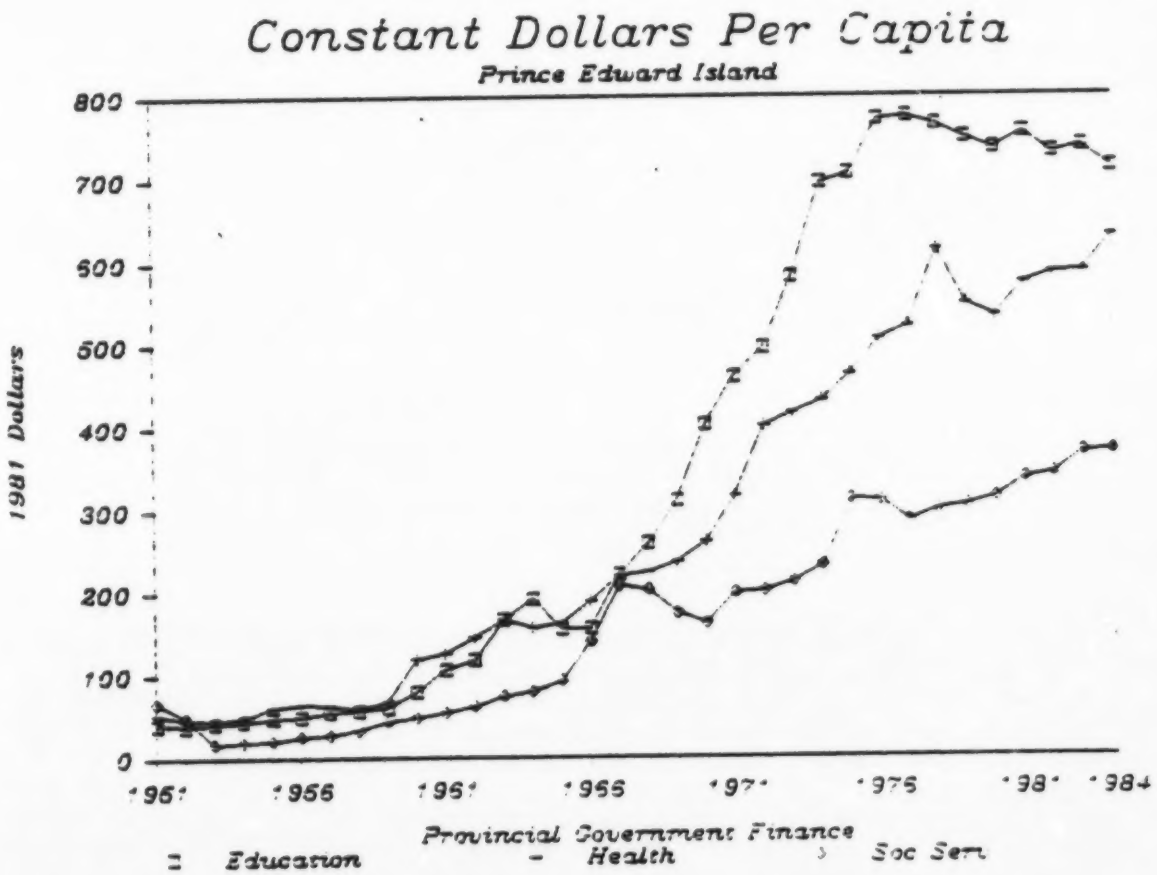
expenditures was devoted to transportation, followed by social services, health and education. Development activities include all the agricultural, fishing, industrial and tourist type activities. They formed only 5.9 per cent of provincial expenditures in 1951. By 1978, these development activities formed nearly 22 per cent of all expenditures. Education had risen to 24 per cent, Health 19 per cent while Social Services slipped to 9.4 per cent and Transportation 10 per cent. The reduction in provincial activities since 1978 was most apparent in Development which was reduced to 8.9 per cent of all spending that year. Health, education and social services together absorbed 57 per cent of all provincial expenditures. Debt charges increased in significance, taking nearly 13 per cent of all expenditures.

Diagram 10 permits one to examine more closely trends in spending on Health, Social Services and Education, in Constant dollars per capita. Each has followed a separate track since

Diagram 10



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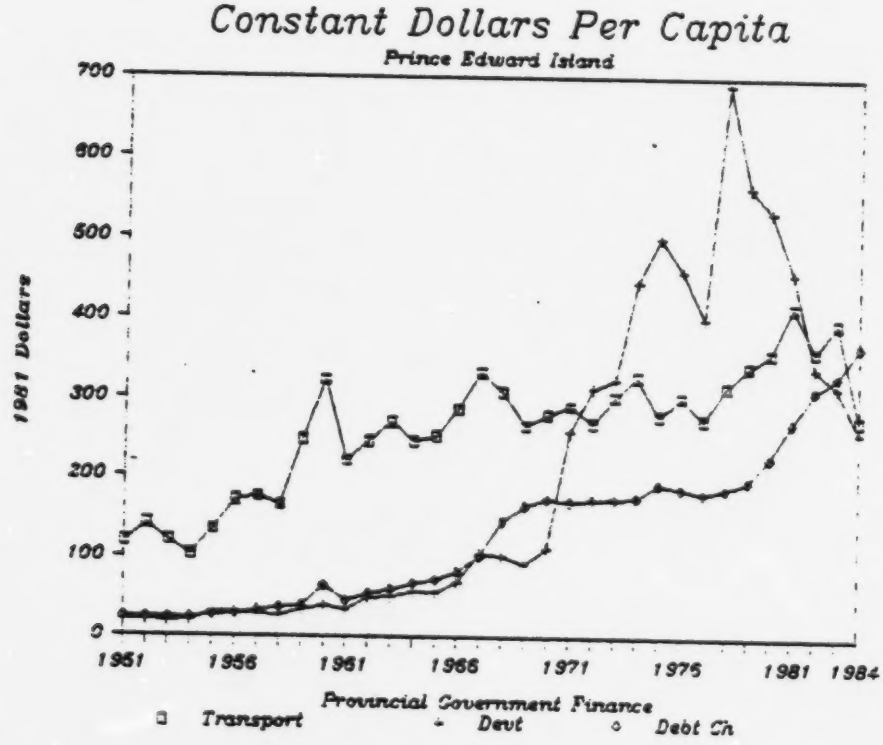
1967. Education has been the largest expenditure function since then and it clearly peaked in 1975 since when it declined somewhat, influenced by a declining school population. Expenditures on health climbed sharply to 1978, falling in 1979 and 1980, and appear to have resumed expanding in more recent years. Expenditures on Social Services have increased at a lesser rate, but steadily nonetheless.

Diagram 11 examines expenditures on Transportation, Development and Debt Charges in the same terms, i.e. Constant $ per capita. One can see that although transportation lost

Diagram 11



its place as the dominant function in later years, its actual level did not decline in absolute terms until very recently. Development activities enjoyed the most extraordinary gains from 1970, to peak in 1978, with a subsequent rapid decline to 1984. Despite this decline these activities remained above the pre Development Plan level of before 1971. Debt Charges are included in this diagram because they have recently begun to impact significantly on provincial finances. In 1984 they had become larger than total Development activities and were roughly equivalent to expenditures on Social Services. Furthermore they have been growing rapidly since 1980 reflecting the

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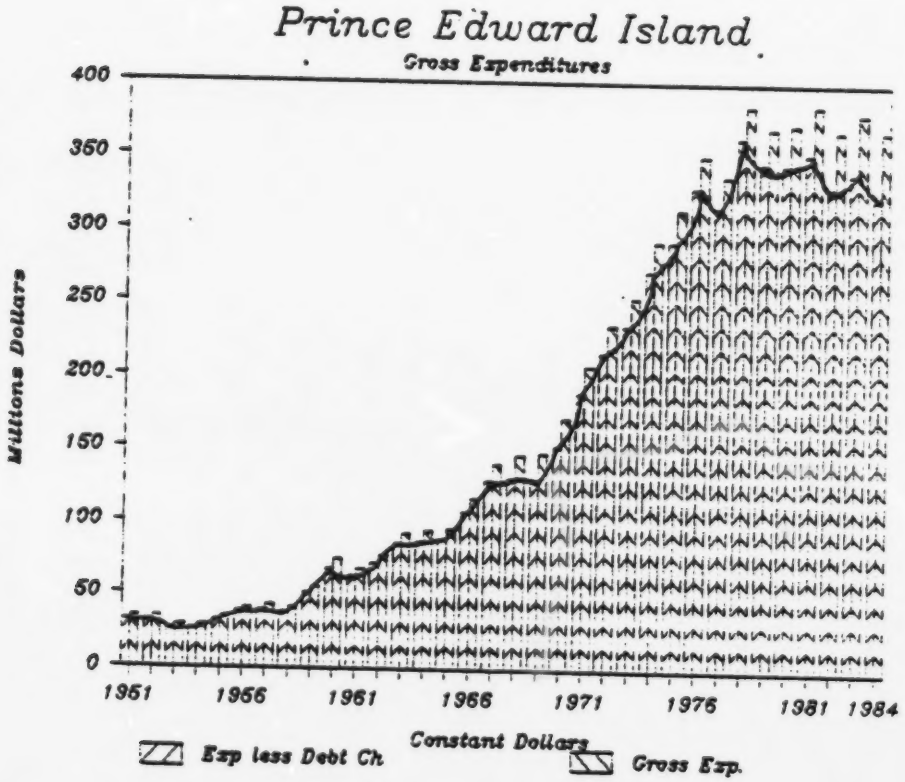
extremely high interest rates that have characterized the early 1980's. Borrowing has not been great by comparison with early times, but in the context of declining federal transfers weak economic conditions and high interest rates, debt charges have become unduly significant.

The effect of increasing debt charges in recent years has been to force other expenditures down in light of revenue constraints. This is shown in constant $ in Diagram 12. This is not in per capita terms in order to demonstrate the overall changes in provincial spending.

Diagram 12



6. Summary and Conclusions

The purpose of this issue of Economic Trends is to provide insights into the provincial government's revenues and expenditures. We have attempted to touch on the major aspects

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of this in an admittedly cursory fashion. Nonetheless it hopefully provides some understanding of events during the past 33 years, leading up to the present difficult period of adjustment. Notwithstanding this, the Province has now moved away from extreme dependence on federal transfers, and is providing over one half its revenues from its own revenue sources. Future growth of federal transfers continues to be problematic and various fiscal arrangements are subject to scrutiny. Thus the major potential for growth of provincial revenues lies in economic gains, and principally gains to incomes and personal expenditures.